No. 15025

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HAROLD WEBER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOLLY WEBER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitions to Review Decisions of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

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TOPICAL INDEX

PAGE

Jurisdiction 1

Statement of the case 2

Question presented 3

Argument 4

I.

The Tax Court erred as a matter of law in finding that the loss sustained by the petitioners from the compromise or settlement of the balance of the purchase price owed them was a capital loss 4

II.

The loss sustained by a creditor upon the compromise or cancellation of indebtedness is not a capital loss as it does not arise from a sale or exchange under the 1939 Internal Revenue Code 10

III.

The losses sustained by the appellants were fully deductible under Section 23 of the 1939 Internal Revenue Code 13

IV.

The cases relied upon by the Tax Court in support of its decision are distinguishable 17

Conclusion 19

TABLE OF AUTHORITIES CITED

Cases

Case	PAGE
B. F. Avery and Sons, Inc., 26 B. T. A. 1393	9
Bagley and Sewall Co., 20 T. C. 983	16
Barnes v. Commissioner, 45 B. T. A. 267	6
Bingham v. Commissioner, 105 F. 2d 971	11
Borin Corporation, 39 B. T. A. 712, 117 F. 2d 917	17
Bowers v. Kerbaugh Empire, 271 U. S. 170	9
L. D. Coddon and Bros. v. Commissioner, 37 B. T. A. 393	9
Commonwealth, Inc. v. Commissioner, 36 B. T. A. 850	13
Consolidated Gas Co., 24 B. T. A. 901	9
Earle, Stewart E., v. Commissioner, 9 T. C. M. 1181	7, 12
Fairbanks v. United States, 306 U. S. 436	13
Gannon v. Commissioner, 16 T. C. 1134	16
Guggenheimer, Charles S., 8 T. C. 789	8, 17
Hale v. Helvering, 85 F. 2d 819	11, 12
Helvering v. Community Bond and Mortgage Corp., 74 F. 2d 727	16
Hutchenson v. Commissioner, 17 T. C. 14	16
I. T. 4018, 1950, 2 C. B. 20	7
Jenckes Co., Inc., 4 B. T. A. 765	7
Lee v. Commissioner, 119 F. 2d 946	11
C. F. Mueller Co., 40 B. T. A. 195	6
Pinkney Packing Co., 42 B. T. A. 823	18
Pressed Steel Car Co., Inc., 20 T. C. 198	16
Russell Wheel Foundry Co., 3 B. T. A. 1168	8
Sherman v. Helvering, 74 F. 2d 742	16
United States v. Burrows Bros. Co., 133 F. 2d 772	13
United States v. Kirby Mfg. Co., 284 U. S. 1	9
West Coast Securities Co. v. Commissioner, 14 T. C. 947	8, 14, 15

Statutes

PAGE

Internal Revenue Code of 1939, Sec. 23(e) 3, 13, 14, 19
Internal Revenue Code of 1939, Sec. 117(a)(5) 7, 10, 13, 19
Internal Revenue Code of 1954, Sec. 7482 1
Internal Revenue Code of 1954, Sec. 7483 1
United States Code Annotated, Title 26, Sec. 7482 1

Miscellaneous

5 Mertens, The Law of Federal Taxation (1953), pp. 417, 418.. 11
Treasury Regulations (1939), Sec. 29.23(e)-1 6
Treasury Regulations (1939), Sec. 39.23(e)-1(b) 6

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Petitions to Review Decisions of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

Jurisdiction.

This case is before the above entitled Court upon appeals from decisions of the Tax Court of the United States entered in docket numbers 39559 and 39560 on September 2, 1955. Petitions for review [R. 49-53] of both said decisions were duly filed and jurisdiction of this court was invoked under the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954 (26 U. S. C. A. 7482, *et seq.*).

The decision of the Tax Court of the United States, from which these appeals are taken, is reported in 24 T. C. 529.

Statement of the Case.

The Respondent assessed deficiencies in the income tax for the calendar year 1947 against both Petitioners arising out of the disallowance as an ordinary loss of losses sustained by the Petitioners upon the compromise of indebtedness arising from the sale of their partnership interests in a sportswear manufacturing business to their co-partners.

On February 1, 1947, the Petitioners sold their respective partnership interests in the business to the four remaining partners, and executed a Bill of Sale therefor to the purchasers. Partial payment of the purchase price was made shortly thereafter. The balance was to be paid in fixed installments over a period of several years.

The Petitioners then moved to California, and about seven months later encountered serious financial difficulties in a similar business in that state. To prevent their complete insolvency, the Petitioners opened negotiations with the purchasers in order that they might receive a lump sum cash payment in anticipation of the installments due in the future. These negotiations resulted in the acceptance by the Petitioners in August, 1947, of a lump sum payment in cash in full settlement of the balance due to them from the purchasers. This sum was $23,268.13 less than the balance of the purchase price which the

purchasers would have been required to pay in installments over the next few years.

In their income tax returns for the calendar year 1947 the Petitioners treated their respective shares of the cancelled indebtedness of $23,268.13 as an ordinary loss. This loss was subsequently disallowed by the Respondent and income tax deficiencies were assessed against the Petitioners resulting from said disallowance.

The Tax Court found that the losses sustained by the Petitioners were capital losses resulting from a reduction of the sale price of their partnership interests.

It is the position of the Petitioners that the settlement or compromise agreement under which they accepted a lesser sum in cash for the balance of the purchase price owed them from the sale of their partnership interests was, in fact, a discount of an obligation to pay money or a cancellation of indebtedness, or a loss incurred in business, fully deductible as an ordinary loss under Section 23(e) of the Internal Revenue Code of 1939.

Question Presented.

The sole question for determination by this Court is whether the loss sustained by the Petitioners as a result of the compromise of the amounts due them from the sale of their partnership interests is an ordinary or a capital loss.

ARGUMENT.

I.

The Tax Court Erred as a Matter of Law in Finding That the Loss Sustained by the Petitioners From the Compromise or Settlement of the Balance of the Purchase Price Owed Them Was a Capital Loss.

The fundamental question for determination by this Court is the character of the loss sustained by the Petitioners upon the compromise of the indebtedness owed them by the purchasers of their partnership interests.

There is no question as to the facts of these cases. The Petitioners and Respondent entered into a Stipulation of Facts involving all the material elements of this case prior to trial. The findings of the Tax Court [R. 41-45] were based upon said Stipulation and accurately set forth the facts involved.

In order to determine the nature of the transaction which gave rise to the loss sustained by the Petitioners, it is advisable to examine the events that led up to the compromise of August, 1947.

The Petitioners and their co-partners entered into a Dissolution Agreement [Ex. 3, R. 22] on September 6, 1946, which set forth the terms and conditions under which the Petitioners would withdraw from the partnership and provided for the purchase of their partnership interests by the remaining partners. It should be noted that the purchase price was the book value of such interests as of the agreed date of dissolution, namely Janu-

ary 31, 1947. A reading of paragraph 2 of the Dissolution Agreement [R. 23] reveals that the remaining partners had an option to purchase the partnership interests of the Petitioners. The actual sale to the remaining partners did not take place until February 1, 1947, almost five months after the Dissolution Agreement was executed. There can be no doubt but that the purchase price was reasonable and that the parties to the sale dealt at arm's length and in good faith.

Pursuant to the Dissolution Agreement, the Petitioners withdrew from the partnership on January 31, 1947. On the following day, February 1, 1947, they executed a written Bill of Sale [Ex. 5, R. 27], transferring to the purchasers all of their title and interest in the partnership.

The effect of the execution of the Bill of Sale was to fully and completely divest the Petitioners of all of their property rights and interests in the partnership assets owned by them. The Petitioners retained no interest whatsoever in the partnership or any of its assets. The purchasers assumed all of the partnership liabilities and obligations. The only connection between the Petitioners and the purchasers was the relationship of creditor and debtor. As of February 1, 1947, the purchasers became indebted, under the Dissolution Agreement of September 6, 1946, to the Petitioners in the sum of $73,953.56, which was to be paid in installments over a period of years. This obligation was not represented by a note or other evidence of indebtedness. It was merely an unsecured

contractual obligation to pay a certain sum of money in installments over a period of time.

It is the contention of the Petitioners that the sale of their partnership interests on February 1, 1947, was a completed and closed transaction for income tax purposes. It is well settled law that the gain or loss upon the sale of a capital asset, such as a partnership interest, is recognized only upon the completion or close of such sale. Losses must, in general, be evidenced by closed and completed transactions, fixed by identifiable events, to be deductible from gross income. 1939 Treas. Regs., Secs. 39.23(e)-1(b) and 29.23(e)-1; *C. F. Mueller Co.,* 40 B. T. A. 195; *Barnes v. Commissioner,* 45 B. T. A. 267 (1941). A closed transaction occurs when there is a sale or other transfer of title to property. It is manifest therefore, that the sale of the Petitioners' partnership interests was completed and closed as of February 1, 1947. Title had passed and there were no contingencies or events to happen at some future date to complete this transaction. Accordingly, Petitioners, in their 1947 income tax returns, reported a slight loss which they realized from these sales.

Some seven months later the Petitioners, as creditors, accepted the sum of $35,000.00 in cash in satisfaction of the unpaid balance of $58,268.13 due them from the purchasers at that time. There can be no argument but that the only relationship existing at that time between the Petitioners and their former partners was that of creditor and debtor. The effect of the acceptance of a lesser sum by the Petitioners and the resulting cancellation of the balance of the purchase price was, in every

sense, a cancellation of indebtedness resulting in an ordinary loss to the Petitioners.

It is well settled law that the cancellation of indebtedness or compromise of a monetary obligation results in an ordinary loss to the forgiving creditor. *Earle v. Commissioner,* 9 T. C. M. 1181 (1950); *Jenckes Co., Inc.,* 4 B. T. A. 765.

While it is true that a loss on the sale or exchange of a capital asset is a capital loss, nevertheless, if the transaction is in fact a settlement of a monetary obligation resulting in the cancellation of indebtedness instead of a sale or exchange, the result is an ordinary loss. Thus where a mortgagee accepted less than the full amount due on a mortgage before maturity, he was entitled to an ordinary loss. *I. T. 4018, 1950*—2 C. B. 20. That ruling of the Treasury Department involved a taxpayer who sold a capital asset, namely his farm, for $15,000.00, receiving $5,000.00 in cash and a $10,000.00 purchase money mortgage payable over a period of years. The next year, when the taxpayer was in need of additional funds, he accepted $9,000.00 in cash from the purchaser in full satisfaction of the unpaid balance of the purchase price, resulting in a $1,000.00 loss to him. It should be pointed out that at the time of the compromise, the purchaser was fully able to pay the entire amount of the indebtedness and there had been no decrease in the value of the mortgaged property. The Treasury Department ruled that the transaction was not a sale or exchange under Section 117(a) of the 1939 Internal Revenue Code, and that the loss was fully deductible as an ordinary loss. The Treasury Department reasoned that the property of the taxpayer in the mortgage was extinguished by allow-

ance of a discount and payment of the balance of the mortgage indebtedness. The only difference between that ruling and the case under consideration is that in the former the indebtedness was secured by real property mortgage, whereas in the case at hand there is no security involved at all.

The Tax Court has held that where a creditor in need of cash accepts less than the face amount in compromise and settlement of a debt not yet due from a solvent debtor, the result is an ordinary loss. *Charles S. Guggenheimer,* 8 T. C. 789. The courts have reasoned that the settlement completely extinguishes the debt, leaving no balance which may be regarded as an unpaid debt. *West Coast Securities Co. v. Commissioner,* 14 T. C. 947 (1950).

The Tax Court has also ruled that an ordinary loss deduction may result from a compromise arising out of a mutual release such as is found in the case under consideration. *Russell Wheel Foundry Co.,* 3 B. T. A. 1168. That case differs from the facts under consideration in that the debtor had asserted certain counter claims against the creditors. The Commissioner, in assessing a deficiency arising from disallowance of the ordinary losses taken by the taxpayer, contended that the mutual releases constituted a sale or exchange, depriving the taxpayer of an ordinary loss. However, the Tax Court held that there was no sale or exchange and allowed an ordinary loss to the petitioners.

In reason and logic, if the cancellation or compromise of indebtedness by a creditor results in an ordinary loss to him, such forgiveness should result in gain or taxable income to the debtor. Certainly the Respondent shall not be permitted to take inconsistent positions in a factual

situation such as this. Therefore, it is certainly reasonable to examine the many cases decided by the courts which have held that the forgiveness or cancellation of indebtedness results in income to the debtor, in order to establish that the same transaction results in an ordinary loss to the creditor.

An example of such cases is that of *L. D. Coddon and Bros. v. Commissioner,* 37 B. T. A. 393 (1938). There the taxpayer-debtor satisfied an indebtedness of $19,-250.00, secured by a mortgage on real property, for the sum of $12,000.00. The taxpayer contended that, as the Respondent does in the case at hand, the transaction by which the original debt was satisfied at less than its face value was merely an adjustment of the purchase price, resulting in a capital loss. The Board of Tax Appeals rejected that reasoning and held that where a solvent debtor is under a direct obligation to make payments for property purchased by him and satisfies that obligation by paying less than the amount called for by the obligation, the transaction will result in taxable income to the debtor in the amount by which the face value of the obligation exceeds the amount paid by him for its satisfaction. Therefore, conversely, the loss sustained by the seller as a result of the settlement of the obligation should be treated as an ordinary loss to off-set the gain or income taxed to the debtor.

To the same effect that the cancellation of indebtedness is income to the debtor are the following cases: *Bowers v. Kerbaugh Empire,* 271 U. S. 170 (1925); *United States v. Kirby Co.,* 284 U. S. 1 (1931); *Consolidated Gas Co.,* 24 B. T. A. 901 (1931); *B. F. Avery and Sons, Inc.,* 26 B. T. A. 1393 (1932).

II.

The Loss Sustained by a Creditor Upon the Compromise or Cancellation of Indebtedness Is Not a Capital Loss as It Does Not Arise From a Sale or Exchange Under the 1939 Internal Revenue Code.

The Respondent has taken the untenable position that the lost sustained by the Petitioners is a capital loss subject to capital loss limitations under the provisions of Section 117(a) of the 1939 Internal Revenue Code which was in effect at the time of the transaction involved here.

It is manifest that if the Respondent is to sustain this position, he has the burden of establishing that the transaction entered into in August, 1947, by the Petitioners and their former partners comes within the definition of a capital loss as contained in the 1939 Internal Revenue Code.

Section 117(a)(5) of that Code defines a long-term capital loss in the following terms:

> "The term 'long-term capital loss' means loss from the *sale or exchange* of a capital asset held for more than six months, if and to the extent that such loss is taken into account in computing net income." (Emphasis added.)

Petitioners concede that the debt in their hands was a capital asset but contend that its compromise is not a sale or exchange under the tax laws.

The courts have consistently held that the compromise, correction or settlement of indebtedness does not involve a "sale or exchange" which can give rise to a capital

gain or loss. This rule has been set forth in Mertens, The Law of Federal Taxation (1953), Vol. 5, pp. 417, 418:

> "If there has been no sale or exchange, there can be no capital loss except in the case of securities, which become worthless, bonds which are returned and losses from short sales. A cancellation of a debt in return for a partial payment is not a sale or exchange."

A creditor who collects on his claim neither sells nor exchanges his property interest in the debt. The claim is extinguished, fully or in part, but it is not transferred in any sense of the word. *Lee v. Commissioner,* 119 F. 2d 946; *Bingham v. Commissioner,* 105 F. 2d 971. Such extinguishment of a claim by payment or settlement is the contrary of a sale or exchange. The same is true of a partial satisfaction, whether the creditor gives the debtor, by way of compromise, discharge in full or remains entitled to the unpaid balance.

In the case of *Hale v. Helvering,* 85 F. 2d 819 (1936), the court stated:

> ". . . the compromise with the maker, who is able to pay then, of promissory notes, for less than their face value, does not constitute a sale or exchange of capital assets . . . there was no acquisition of property by the debtor, nor transfer of property to him. Neither businessmen nor lawyers call the compromise of a note a sale to the maker. In point of law and in legal parlance property in the notes as capital assets was extinguished, not sold. In business parlance the transaction was a settlement and the notes were turned over to the maker, not sold to him. In *John H. Watson, Jr. v.*

Commissioner of Internal Revenue, 27 B. T. A. 463 . . . it was held that the payment at maturity, of the face amount of bonds purchased at a premium, was not a sale or exchange resulting in a capital loss. If the full satisfaction of an obligation does not constitute a sale or exchange, neither does partial satisfaction. . . ."

The reasoning of the *Hale* case, *supra,* is applicable to the facts in the case under consideration. The transaction of August, 1947, was nothing more than the compromise of indebtedness owed to the Petitioners by their former partners. The Petitioners agreed to accept a part of the amount owing to them in complete satisfaction and extinguishment of the balance of the purchase price. A document entitled "Mutual Release" [Ex. 6, R. 35] was executed by both parties setting forth the amounts which were then due to the Petitioners and providing that they agreed to accept a specified lesser sum in full settlement of the balance due. It further provided that the Petitioners ". . . agree to forgive and cancel the balance of said obligation of (the purchasers) in consideration of an exchange of mutual releases." A reading of paragraphs 1 and 2 of the Mutual Release [R. 37] indicates that the agreement was in fact a complete mutual release and discharge of all claims and obligations between the parties. The Tax Court has recently ruled that a mutual release or surrender of claims such as found in the case at hand does not constitute a sale or exchange. *Stewart E. Earle v. Commissioner,* 9 T. C. M. 1181 (1950).

The rule that an amount received in payment or compromise of an obligation by the creditor is not received on a sale or exchange thereof has been consistently ad-

hered to by the courts. *Commonwealth, Inc. v. Commissioner,* 36 B. T. A. 850 (1937); *Fairbanks v. United States,* 306 U. S. 436; *United States v. Burrows Bros. Co.,* 133 F. 2d 772.

It is submitted, in view of the foregoing discussion and the authorities cited in support thereof, that the compromise agreement of August, 1947, was not a sale or exchange within the meaning of Section 117(a)(5) of the 1939 Internal Revenue Code. It follows, therefore, that the loss sustained by the Petitioners was not a capital loss.

III.

The Losses Sustained by the Appellants Were Fully Deductible Under Section 23 of the 1939 Internal Revenue Code.

Section 23(e) of the 1939 Internal Revenue Code provides for the deduction from gross income of the following items:

> "(e) Losses by Individuals—In the case of an individual, losses sustained during the taxable year . . .
>
> (1) if incurred in trade or business; or
>
> (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; . . ."

It is submitted that the loss sustained by the Petitioners is such a loss incurred in trade or business, and should be deductible in full. The evidence shows that the Petitioners were in serious financial difficulty with their new business in California in the summer of 1947. Mr. Wener testified [R. 53, 54] that both of the Petitioners invested what money they had, including the first payment received

from the purchasers, in their new business in California. The record shows that the business was operated at a loss and that the Petitioners were compelled to borrow from the Bank of America the sum of $20,000.00, assigning to the Bank their interest under the sale contract as collateral security [R. 54]. Petitioners had exhausted all means for raising money for their business, and, as a last resort, they turned to the remaining balance due them under the sale contract. Part of the $35,000.00 cash received under the terms of the settlement was used to pay off the business loan from the Bank of America and the balance was deposited in the business [R. 55].

The evidence in this case clearly shows that the Petitioners took a loss in order to raise money for their business needs. Any loss sustained from entering into a transaction for business purposes is deductible under Section 23(e)(1), Internal Revenue Code (1939). This should be true where the transaction is a compromise of indebtedness entered into for the specific purpose of raising business funds.

In the case of *West Coast Securities Company v. Commissioner,* 14 T. C. 947 (1950), the petitioner-corporation was allowed a deduction for a business loss under Internal Revenue Code, Section 23 in the amount of the discount given in the settlement of a debt, though the debtor was solvent and there was little question but what it would be fully paid when due. In holding that the taxpayer was entitled to an ordinary loss deduction as a result of the compromise settlement of certain notes it held with the maker, the Court stated:

> "The obligations which were compromised by the petitioner had not matured at the time of settlement,

and the compromise did not stem from any determination of probable worthlessness, but arose as a necessary incident of petitioner's liquidation."

In that case it was necessary for the taxpayer to raise cash quickly in order to meet its debts and to make liquid funds with which to make distribution to its stockholders. The Court reasoned further:

> "There is no disagreement between the parties that petitioner sustained an out-of-pocket loss in the amount of $43,577.50, as the result of . . . (the settlement) . . . The income tax is levied on a taxpayer's net income, and, to determine such net income, all genuine losses actually sustained by the taxpayer during the taxable year in connection with regular business transactions or transactions entered into for profit are generally allowable. * * * We know of no cases, no provisions of the statutes, or no reason why the loss suffered may not be deducted in determining petitioner's taxable net income * * *."

By analogy, it is submitted that if the compromise of notes with the maker by a corporation, necessitated by a desire for immediate cash funds, as in the *West Coast Securities* case, *supra,* gives rise to a business loss, then the same should be true with respect to an individual taxpayer. In discounting the obligations of their former partners to raise immediate cash for their business, the Petitioners sustained a business loss in every sense of the word.

Even if the Court should decide that the compromise of August, 1947, was a sale or exchange of a capital asset by the Petitioners, the evidence is clear that such a transaction was entered into not for the purpose

of realizing a gain or a loss on such a capital transaction, but rather in order to accomplish a necessary business purpose. There are many cases in which the courts have held that because of the business purpose behind the transaction, the taxpayer should be allowed to deduct a claimed loss on the sale of exchange of a capital asset in full as a business loss even though the loss otherwise meets the specifications of a capital loss. *Helvering v. Community Bond and Mortgage Corp.*, 74 F. 2d 727; *Pressed Steel Car Co., Inc.*, 20 T. C. 198 (1930); *Bagley and Sewall Co.*, 20 T. C. 983 (1930).

The Tax Court has even held that where an attorney withdrew from a law firm, forfeiting his partnership interest, that the resulting loss was incurred in trade or business and fully deductible. *Hutchenson v. Commissioner*, 17 T. C. 14 (1951); *Gannon v. Commissioner*, 16 T. C. 1134 (1951); *Scherman v. Helvering*, 74 F. 2d 742. These cases involve the forfeiture of a capital asset for business reasons which is allowed as an ordinary loss. This is substantially in effect what the Petitioners were required to do with the portion of the indebtedness cancelled by them in order to save their business in California. They were compelled to forfeit that portion of the purchase price which the Respondent contends is a capital loss solely to obtain working capital for the business [R. 44 and 54, 55]. For that reason they should be allowed to deduct their loss in full under the reasoning of the above authorities.

IV.

The Cases Relied Upon by the Tax Court in Support of Its Decision Are Distinguishable.

The decision of the Tax Court in the cases under consideration [R. 45] is apparently based upon the theory that because the settlement between the Petitioner and their former partners was consummated in the same year as the sale and prior to the payment of any of the installments on the purchase price, that the transaction was in effect no more than a renegotiation or adjustment of the original sales contract of February 1st of that year. Such reasoning is contrary not only to logic, but also to previous Tax Court decisions holding that where a creditor releases a solvent debtor, prior to maturity, from part of the debtor's obligation because it was to the financial interest of the creditor to do so that the resultant loss was fully deductible by the creditor. *Charles S. Guggenheimer,* 8 T. C. 789. In reason and logic, it should make no difference whether the settlement was entered into before or after the obligation to pay had matured. In either case, the indebtedness is fixed both as to amount and time of payment. The obligation to pay is absolute. The economic effect of accepting a lesser sum for the balance of the purchase price is identically the same in either case. Therefore, the tax effect of such a compromise of indebtedness should be the same in both instances. There is no basis in law or fact for according different treatment to a release of liability depending upon when the indebtedness is forgiven.

The Tax Court also relied upon the case of *Borin Corporation,* 39 B. T. A. 712, affd. 117 F. 2d 917. That case is clearly not in point for the reason that it

involved the execution of a second sale contract between the seller and purchaser which expressly rescinded and cancelled the original contract. The purchase price under the second contract was substantially reduced in settlement of the purchasers claims for breach of contract and warranty under the original sales contract. There was no true cancellation of indebtedness. The terms and conditions of the second contract differed materially from those contained in the original. The court properly concluded that the first sales contract had been mutually cancelled and that the second contract became the only agreement between the buyer and seller. The facts in that case are entirely different from the case at hand. Here we have only one contract, and no claims for its breach by the purchasers which would entitle them to compensation or damages. Further, we have no rescission of the original contract and substitution of another in its place differing substantially in terms and conditions.

The case of *Pinkney Packing Co.,* 42 B. T. A. 823 (1940), cited by the Tax Court in support of its decision, involved the question of the treatment of the release by the seller of a part of the purchase price which the buyer was obligated to pay in installments over 10 years in consideration for a lump cash payment. However, it should be noted that it was agreed between buyer and seller at the time the sale was executed that the buyer would have the option to purchase the property by a lump sum payment at any time during the installment period. That case did not involve a true forgiveness or cancellation of indebtedness, but rather the interpretation of the option given to the buyer at the time the sale was consummated to purchase the property for a lump

sum, as an alternative to an installment purchase. The case is further distinguishable as the seller retained a lien on the property as security.

Conclusion.

Under Points I and II Petitioners have established that the compromise of a monetary indebtedness, whether it be based on inability to collect or by reason of anticipating the payment of the indebtedness, is not a sale or exchange within the meaning of Section 117(a)(5) of the Internal Revenue Code of 1939. Therefore, the compromise agreement entered into in August, 1947, by them could not result in a capital loss.

The compromise agreement of August, 1947, was clearly a separate and independent transaction, having no relation, either legally or in logic, to the sale of the partnership interests on February 1, 1947. The latter transaction was a completed and closed event, not only in common business understanding and usage, but also under the tax laws. The Petitioners retained no interest, directly or indirectly, in their partnership assets and they reported the resulting capital loss from the closed transaction on their 1947 income tax returns.

The settlement transaction was the result of arms-length negotiations entered into in good faith months after the completed sale of February 1st of that year. It was, in fact, a true and genuine cancellation of indebtedness resulting in complete extinguishment of all obligations, and should be treated as an ordinary loss, deductible in full by Petitioners. The additional reasons set out in Point III support the conclusion that the loss sustained should be allowed as one incurred in trade or business under the provisions of Section 23 of the 1939 Internal

Revenue Code. As has been incontrovertibly shown the loss was sustained by the Petitioners solely and simply for business reasons, and therefore should be allowed as a business loss.

For the reasons stated above and the arguments set forth in this brief, it is respectfully submitted that the decisions of the Tax Court should be reversed and judgment entered in favor of the Petitioners.

Respectfully submitted,

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June 1, 1956.